BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
OFFICE OF THE COMPTROLLER OF THE CURRENCY

August 13, 2002

The Honorable John D. Dingell
Ranking Member
Committee on Energy and Commerce
U.S. House of Representatives
Washington, D.C. 20515-6115

Dear Representative Dingell:

This letter is in response to your letter of July 11, 2002, to the Board of Governors of the Federal Reserve System and the Office of the Comptroller of the Currency in which you raise questions about whether banks are tying the availability or price of credit to investment banking services.

As you know, section 106 of the Bank Holding Company Act Amendments of 1970 prohibits, with certain exceptions, a bank from extending credit or varying the terms of credit on the condition that a customer purchase another product or service from the bank or its affiliates. In addition, to the extent that this conduct involves a bank reducing the price of credit to benefit an affiliate's investment banking business, it would also violate section 23B of the Federal Reserve Act, which requires that transactions involving a bank and its affiliate be on market terms. Finally, in certain circumstances, this practice may, by reducing the bank's income for the benefit of an affiliate, be an unsafe and unsound banking practice.

As bank supervisors, we share your concerns about the potential for tying and have in place and will continue our supervisory efforts to ensure compliance with section 106, other banking statutes and safe and sound banking practices. As provided in the Board's Supervision Manuals governing Bank Holding Company and State Member Bank Examinations, compliance reviews of a bank holding company and state member bank include evaluation by examiners of the institution's program for compliance with section 106. Similarly, as provided in the OCC Bulletin 95-20, the OCC expects national banks to adopt and implement systems and controls to promote compliance with anti-tying provisions. As a regular part of the OCC's on-site safety and soundness review process for national banks, examiners review policies and procedures, internal reviews of loans, audit and internal control assessments and, if tying issues are raised, will conduct further reviews to determine if appropriate corrective action has been taken or initiated to address any tying issues or supervisory concerns including non-compliance with section 106.

In light of reports such as those mentioned in your letter, staff of our agencies are working together on a special targeted review of the tying issue at several of the country's largest banks. In particular, staff, including legal staff, will review bank policies and procedures governing tying, marketing programs, training materials and the adequacy of internal audits for compliance with a bank's internal policies and procedures. Based on the results of this review, the agencies will determine whether additional steps are necessary. Moreover, if our agencies find banks offering credit on an impermissible basis, we will take appropriate supervisory action to assure compliance with the law and to terminate unsafe and unsound banking practices.

Responses to the individual questions you asked in your letter are set forth in the attached Appendix. We hope that these adequately address your concerns on these important matters.

Sincerely yours,

Alan Greenspan
Chairman
Board of Governors of the
Federal Reserve System

Sincerely yours,

John D. Hawke, Jr.
Comptroller of the Currency

APPENDIX

1. **Has the Federal Reserve or OCC made inquiries into the tying practices outlined with increasing frequency in the financial press? Have you issued any guidance or warnings to your member banks in the 2000-2002 time period or considered any hearings or investigations into these apparent violations of the law? If not, please explain your rationale for ignoring this problem.**

The Board and the OCC take seriously the obligation of banks to comply with the antitying provisions of section 106 of the Bank Holding Company Act Amendments of 1970 (12 U.S.C. § 1972(1)) ("section 106"). As you know, section 106 prohibits a bank from extending credit or varying the terms of credit or any other product on the condition that a customer purchase any other product or service from the bank or its affiliates. This antitying provision was enacted in 1970 to address concerns that banks would use their presumed market power in the loan business to expand their market share in other nonbank business segments by forcing bank customers to obtain additional products or services from the bank or its affiliates as a condition of obtaining credit. The statute does, however, exempt certain enumerated traditional bank products, specifically deposits, loans, discounts and trust services, from the tying prohibitions. In addition, the Board was given the authority to provide additional exemptions to the tying prohibitions, but has done so infrequently. Further, customers or competitors who believe they have suffered injury to their business or property due to violations of section 106 may pursue treble damages in a civil suit.

When either agency receives allegations of tying, the agency conducts inquiries and will initiate appropriate actions to remedy any violations of the antitying provisions that are found. Working together, our agencies are conducting a special targeted review of the circumstances described in the press and referenced in your letter. In particular, the agencies, including legal staff, will review the antitying training and compliance programs, marketing programs, training materials and adequacy of internal audits for compliance with the bank's internal policies and procedures at several of the country's largest banks. These efforts are ongoing, and we have not yet completed our evaluation of the information we have gathered thus far.

Prior to 2000, the Board and OCC separately issued guidance directing banks and bank holding companies to implement and maintain appropriate systems and controls to promote compliance with the antitying provisions. That guidance addressed the need for specific policies and procedures addressing tying prohibitions, training materials and programs that provide examples of prohibited practices and sensitize employees to the concerns raised by tying, compliance systems, and management involvement in reviewing training, audit, and compliance programs related to tying. *See, e.g.,* FRB Bank Holding Company Supervision Manual § 3500.0; OCC Insurance Activities Handbook, Federal Prohibitions on Tying (June 2002); OCC Bulletin 95-20 (April 14, 1995).

In addition, as you know, in 1992 Federal Reserve and OCC staff conducted a joint investigation of alleged tying violations at several large bank holding companies and banks. The results of this examination were discussed in the 1997 report on tying by the General Accounting Office, *Bank Oversight: Few Cases of Tying Have Been Detected*, GAO/GGD-97-58 (May 8, 1997).

2. **To what degree is the pricing of credit being manipulated by commercial banks to build market share in investment banking business? Can the dramatic rise of commercial banks in the rankings of certain products such as investment grade debt underwriting be explained by anything other than tying?**

To date, the agencies have not found that commercial banks are manipulating the pricing of credit to build investment banking market share. Clearly, banking organizations that have credit relationships with customers hope to sell them the bank's full range of products and services. As you know, banking organizations are permitted to package certain services because some tying arrangements are permissible under statutory and regulatory exceptions and some customers may request that the bank package services. In both cases, interested customers have the choice of whether to enter into these arrangements. There are many other entities, besides banks, offering creditworthy customers a wide choice of credit on favorable terms.

We are aware that the combination of a deteriorating lending environment over the last several years, expanded powers under GLBA, and cross-marketing practices of financial services in the banking industry, have prompted changes in lending and investment banking services by banking organizations. Deteriorating credit conditions and advances in credit risk management have prompted many large banking organizations to question the profitability of some traditional corporate loan products and borrowers that previously were considered low-risk. With increasing corporate debt downgrades and problem credits since 2000, some banks have found that products such as revolving lines of credit, term loans, and back-up liquidity facilities may have a higher level of risk than originally anticipated. As a result, banking organizations have been increasingly rationalizing their product pricing in recent years by charging higher spreads on credit facilities, tightening loan terms and conditions, and, in some cases, terminating established credit lines when overall customer relationships do not return sufficient revenues for the risks undertaken.

Certain market forces discourage manipulation of credit pricing by banks to build market share in investment banking. As a practical matter, in the syndicated loan market, no more than three or four participating banks can typically receive investment banking fees from a corporate borrower. However, in the syndicated loan market, 80 percent of the dollar amount of the commitments outstanding in 2001, or $1.6 trillion of the $2.0 trillion in commitments, involved nine or more participating banks and non-banks, a strong indicator that the loan was adequately priced on a stand-alone basis.

The increase in investment banking market share at larger bank affiliates may be attributable to a number of market and competitive factors not associated with tying. A significant factor has been industry consolidation and the acquisition of investment banking firms by banking organizations. Although the number of bank-affiliated broker-dealers ranked in the top ten underwriters of all U.S. debt and equity offerings rose from two in 1996 to six by the end of 2001, each of the four new entrants to the top ten appear to have achieved their 2001 rankings primarily through the acquisition of established investment firms. For example, Citigroup's rise to number one in the top ten arose primarily through the acquisition of both Salomon Brothers and Smith Barney – firms that ranked 4th and 10th in the 1996 league tables, respectively. Similar explanations underlie the rankings of other highly ranked bank-affiliated securities underwriters.[1]

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[1] Other bank-affiliated underwriters ranking in the top ten as of year-end 2001 but not ranked in 1996 include: BofA Securities, comprised of Bank of America's and NationsBank's former Section 20 subsidiaries, plus Montgomery Securities; UBS, which acquired Paine Webber/Warburg; and Deutsche Bank, which absorbed Deutsche Morgan

Statutory and regulatory changes that have enhanced the ability of banking organizations to conduct underwriting and dealing activities are also a significant contributing factor to bank affiliates' increasing standing in the underwriting league tables. Until the passage of the Gramm-Leach-Bliley Act (GLBA), banking organizations conducted limited corporate investment banking activities through Section 20 non-bank subsidiaries. At year-end 1996, the percentage of revenue that could be derived from bank-ineligible securities activities of Section 20 subsidiaries was capped at 10 percent. In March 1997, the Board raised the Section 20 subsidiary revenue test from 10 to 25 percent of revenue, thereby opening the door for bank holding companies to compete more effectively for corporate securities business. The passage of GLBA eliminated the revenue cap for financial holding companies and also allowed financial subsidiaries of national banks and financial holding companies to engage in investment banking activities. Accordingly, it is likely that the former low ranking of bank-affiliated broker-dealers on the securities underwriting league tables was, in part, a result of constrained powers. The recent rise of bank-affiliated broker-dealers may be, in part, a result of the ability of banking organizations to better meet demand by corporate customers for financial services.

With respect to banks' growth in investment grade debt underwriting in particular, debt security underwriting is a natural area of growth for banking organizations given their established expertise in making credit decisions on loans. This is buttressed by the fact that institutional bond investors have, over the past several years, increasingly looked to the syndicated and secondary loan markets for investment candidates. This has enabled banking organizations to reap potential synergies from marketing both lending and security underwriting capabilities to corporate customers while providing a variety of investment products to institutional investors.

This situation has been particularly advantageous in recent years as corporate customers have shown significant demand for intermediate and long-term debt financing at the prevailing low level of market rates instead of shorter term bank loans. Corporate customers have been taking advantage of historically attractive rates in the bond market to pay down bank loans and commercial paper. This trend is due in part to firms needing long-term credit when short-term sources became unavailable out of concerns about creditworthiness and the likelihood of short-term lines of credit being drawn.

3. **Since it appears that credit is being offered as a loss leader by commercial banks to facilitate or leverage the expansion of their investment banking business, what are the implications of such mispricing on the supply of and demand for credit? What are the implications of this underpricing for the financial health of the smaller banks that participate in these syndicated facilities?**

As noted above, if banks were to condition the price of credit on a customer obtaining investment banking or other products or services from an affiliate, with certain exceptions, this condition would violate section 106. This practice may in certain circumstances also be unsafe and unsound because the bank reduces its revenues, and perhaps incurs a loss, for the benefit of its affiliate. Moreover, banks are prohibited under Section 23B of the Federal Reserve Act, 12 U.S.C. § 371c-1, from making an extension of credit to a borrower at below market terms where an affiliate, including an underwriting affiliate, is a "participant" in the transaction or where the proceeds of such extension of credit are used for the benefit of an affiliate. Such extensions of

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Grenfell, Bankers Trust's Section 20 subsidiary and Alex. Brown & Sons Securities. Bank-affiliated institutions that were ranked in the top 10 in 1996 include JP Morgan, which merged with Chase (which had acquired Hambrecht & Quist), and CFSB, which acquired DLJ and the Pershing Trading Company.

credit must be on terms and conditions that are substantially the same, or at least as favorable to the bank, as those prevailing at the time for comparable transactions not involving affiliates, or, in the absence of comparable transactions, on terms and conditions, including credit standards, that in good faith would be offered, or would apply. If a bank offers credit at below market rate as a "loss leader" to induce a prospective customer to use the bank's underwriting affiliate the bank would be in violation of section 23B.

As bank supervisors, we share your concern with banks offering credit on discounted terms in order to facilitate or leverage expansion of their affiliates' investment banking business. If our agencies find banks offering credit on this basis, we will take appropriate supervisory action to assure compliance with the law and to terminate unsafe and unsound banking practices.

The extent to which the pricing of certain credit products in the past has not fully compensated lenders for the ultimate risks undertaken may reflect a cyclical over-optimism about the fundamental credit condition of the borrowers at the time the credit extension was made. However, it is also important to note that such trends in the pricing of credit extend to debt securities as well as bank credit products. As recent experiences in both the debt securities and bank loan market clearly indicate, any past mispricing is currently being corrected.

Small banking organizations are not significantly engaged in the syndicated loan markets. While some regional banks have experienced losses in their syndicated portfolios, our examinations suggest a lack of proper underwriting and due diligence prior to loan commitment is responsible for the rise in problem credits at these institutions. Even then, syndicated loans have generally not been a significant portion of regional or smaller banks' loan portfolios. Among regional firms, asset quality ratios, provisions, net interest margins and return on assets have been superior to that of the large complex banks that have agented syndications for the past several years.

4. **To what degree is this tying activity a cause of the increasing losses being realized by large banks on loans to borrowers such as Enron that were known to pay large investment banking fees? Is the "pay to play" practice leading to a concentration of bad credit risks among an increasingly smaller number of banks? What are the systemic implications of this distortion?**

We have not identified illegal tying by banks and thus do not have evidence that such tying activity was a cause of recent losses. In particular, the syndicated loan facilities extended to Enron were priced within a range of market spreads for similarly rated companies at the time the credit was extended. However, there is the potential for banks to let the profits from cash management, investment banking and other services cloud their objectivity in evaluating the risks of borrowers. Work by supervisors on ensuring that banks enhance the checks and balances to ensure the integrity of internal credit rating systems is a high priority of the banking agencies both for risk management purposes and for preparation of the proposed new Basel Accord. Moreover, current risk management practices have successfully limited the exposure of banks to individual credits and industries through loan sales, credit derivatives, syndications and securitizations.[2] That is one reason why the effects of the current credit cycle have had a more moderate effect on bank financial health than in the early 1990s.

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[2] Large banks manage credit concentrations by establishing house limits that are well below their legal lending limit of 15% of Tier 1 Capital plus the Allowance for Loan and Leases Losses (ALLL). These house limits prevent undue credit concentrations to single obligors. Furthermore, industry concentration limits are established to prevent banks from being overexposed to any one industry relative to its capital base.

5. Does the current accounting model require commercial banks to record their liabilities, including loans and loan commitments, at fair value? Do the financial statements of major banks reflect the economic reality of the above-referenced mispriced credits and huge unrealized losses (and increasingly large realized losses) or are the financial statements misleading to investors?

Banks follow generally accepted accounting principles ("GAAP") for regulatory reports and filings with the Securities and Exchange Commission ("SEC"). GAAP is currently a "mixed attribute" model in which some balance sheet assets and liabilities are accounted for at cost, while other items are accounted for at fair value. This accounting model generally requires banks to record their liabilities at amortized cost. For example, liabilities such as deposits and long-term debt are accounted for at cost. One exception is liabilities related to trading activities, which are accounted for at fair value. However, GAAP does require banks to disclose in the financial statement footnotes the fair value of all assets, liabilities, and commitments that are financial instruments. These disclosures provide investors with important information about the economics and risks of bank assets and liabilities.

For a bank, a loan is considered an asset. Generally, loans are accounted for at their face amount (amortized cost) less an appropriate allowance for uncollectible amounts. However, loans that a bank intends to sell are shown at the lower of cost or market value amount. Loan commitments generally are accounted for off-balance sheet, but banks are required to set up a separate allowance for the portion that they believe is uncollectible. Thus, amounts the bank estimates that it will not receive from collections on the loan or from a sale (if it intends to sell the loan), are reflected in the bank's financial statements.

As mentioned previously, we do not have evidence of significant "mispricing" of bank credits, nor are we aware of "huge" unrealized losses within bank financial statements from any mispricing. The pricing of loan commitments in the banking book of an organization becomes evident in the financial statements through fee income and net interest margin earned on loans. The degree to which credit is "mispriced" may be evident under traditional accounting practices through observation of a compression in net interest margin relative to peer institutions.

"Huge unrealized losses" on loans and loan commitments should not escape recognition in financial statements and Regulatory Call Reports under the current accounting and supervisory regimes[3] in which banks are required to identify and reserve against identifiable and expected loan losses. Moreover, requirements under Financial Accounting Statement 107, for disclosure of fair values in the footnotes of financial statements guard against financial statements being misleading to investors.

Mispricing under a fair value accounting model might be detectable if a loan or commitment has an active market that provides price information. Alternatively, mispricing might be apparent if the fair value of loans and commitments can be modeled from observable market rates for the underlying credits. Mispricing might be more difficult to find if the commitments' fair value is an estimate based on the organization's own assessments of the borrower's credit quality, yields on alternative investments, probability that the commitment will be utilized, and assumptions about the borrower's future credit condition.

[3] Banks are subject to onsite supervision where the adequacy of their ALLL and internal loan grading system is reviewed by bank examiners. Accordingly, loans and/or loan commitments with identifiable loss characteristics would be subject to regulatory classification as well as non-accrual and loan loss reserve treatment as deemed appropriate by bank examiners.